October 31, 1991

**COORDINATED ISSUE**
**RETAIL INDUSTRY**
**INVENTORY SHRINKAGE RESERVES**

## Facts

Situation 1.

Company Y operates retail department, discount, and grocery stores. Y maintains book inventories in accordance with Section 1.471-2(d). Under Y's system of inventory accounting, the total dollar amounts of Y's book inventories, which are consistent with detailed subsidiary records, are adjusted on an ongoing basis for items purchased and sold.

Company Y does not take a physical inventory as of the last day of its taxable year. Instead, Y cycles the physical inventory counts of its stores throughout the year so that each is counted two or three times per year.

Company Y establishes inventory shrinkage reserves for its stores. Y calculates shrinkage losses by determining a moving average ratio of actual shrinkage losses (as determined by prior physical inventory counts) to actual sales for the period. That ratio is then multiplied by the sales of the current month or period for which the reserve provision is being established. Y accumulates the inventory shrinkage reserves until physical inventory is taken, at which time the actual shrinkage loss is charged to the reserve and any overage or shortage is taken into account to reduce the reserve balance to zero. The process then begins again. At year end, an unused reserve balance will exist equal to the estimated shrinkage losses for the period between the time that the last physical inventory was taken and year-end. The reserve balance is used by Y to reduce inventory for book and tax purposes.

Situation 2.

The facts are the same as in Situation 1 except that instead of using sales in its moving average ratio, Y reduces ending book inventories by an estimate to reflect shrinkage as follows:

$$\frac{\text{Actual shrinkage from the beginning of the taxable year through the date of the most recent physical inventory}}{\text{Number of weeks from the beginning of the taxable year through the date of the most recent physical inventory.}} \times \text{Number of weeks from the date of the most recent physical inventory through the end of the taxable year.}$$

**Question**

Whether one period's inventory shrinkage can be estimated on the basis of previously determined shrinkage?

**Law**

Section 471 of the Internal Revenue Code provides that whenever the use of inventories is necessary in order to clearly determine the income of any taxpayer, inventories shall be taken on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Section 1.471-2(c) of the Regulations states that the basis of valuation most commonly used by business concerns and which meet the requirements of Section 471 of the Code are (1) cost, and (2) cost or market, whichever is lower. Section 1.471-3 defines cost for inventory valuation purposes.

Section 1.471-2(d) of the Regulations provides that if the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and are credited with the value of goods used, transferred or sold, calculated upon the basis of the actual cost of the goods acquired during the tax year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. It further provides that the balances shown by the book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

Treasury Reg. 1.471-2(f) identifies certain methods which are not acceptable for purposes of Section 471 inventory valuation. Two such practices are as follows:

> (f)(1) "Deducting from the inventory a reserve for price changes or an estimated depreciation in the value thereof."
>
> (f)(3) "Omitting portions of the stock on hand."

**Discussion**

Under Section 1.471-2(d) of the Regulations the amounts shown in inventory accounts that are maintained on a perpetual basis are deemed to be the cost of the inventory. While the regulations permit the balances in the perpetual accounts to be adjusted as a result of discrepancies that are verified by actual physical counts, the regulations do not permit additional adjustments that a taxpayer anticipates would occur if it were to take a physical inventory at year end. Such an adjustment is nothing more than an unverified guess by Y that its book inventories must be incorrect because they have been verified to be incorrect in the past. Although Y argues that it is, in fact, estimating "actual" shrinkage, it is impossible to determine "actual" shrinkage unless a physical inventory at year end is taken.

In Altec Corp. vs. Commissioner, TCM 1977-438 (Altec) the court held the taxpayer's reduction of its closing inventory via shrinkage estimates did not clearly reflect income and the Service acted properly in utilizing its statutory discretion under Sections 446(b) and 471. The court stated that the taxpayer "has done little to establish the reasonableness and propriety" of the reserves in question.

There is no authority in the code or regulations that permits a taxpayer to reduce its inventory (and thus its taxable income) by an accrued shrinkage estimate. As the Supreme Court noted in Thor Power Tool Co. vs. Commissioner, 439 U.S. 522, 543-44 (1979), 1979-1 C.B. 167, in discussing the fact that conservative accounting principles that are perfectly acceptable for financial reporting purposes may not clearly reflect income for tax purposes:

> Financial accounting in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. This is as it should be. Reasonable estimates may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm's overall financial health; but the accountants' conservatism cannot bind the Commissioner in his efforts to collect taxes. "Only a few reserves voluntarily established as a matter of conservative accounting", Mr. Justice Brandeis wrote for the Court, "are authorized by the Revenue Acts." Brown vs. Helvering, 291 U.S.193, 201-202 (1934), XIII-1 C.B. 223 (1934).

439 U.S. at 543-544.

## Conclusion

A taxpayer may not reduce ending book inventory based on an estimate of shrinkage. Objective evidence of shrinkage is necessary to clearly reflect income under Section 446(b) of the Code and such evidence can only be produced with a physical inventory.